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USSR-China: Prospects for Revitalizing Economic Links

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An Intelligence Assessment

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SOV 87-10079X
December 1987
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An Intelligence Assessment

This paper was prepared by , Office of Soviet Analysis, and , Office of East Asian Analysis, with a contribution by OEA. Comments and questions are welcome and may be directed to the Chief, Economic Performance Division, SOVA

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USSR-China: Prospects for Revitalizing Economic Links

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Key Judgments

Information available as of 18 September 1987 was used in this report.

Economic relations between the USSR and China have flourished during recent years, raising the possibility that Moscow may parlay these closer ties into greater influence with Beijing at the expense of the United States and the West. Total Sino-Soviet trade expanded from just $300 million in 1982 to more than $2.5 billion last year, and Chinese and Soviet leaders have laid the groundwork for even closer links. The 1986-90 trade protocol—the first five-year pact between the two countries—calls for USSR assistance in renovating Chinese industrial projects, more growth in the exchange of goods, and an expansion of cross-border ties.

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Despite the trade boom and ambitious plans for more cooperation, we believe that growing Sino-Soviet economic links will impinge little on US interests:

- Sino-Soviet trade at current levels—or even under the planned expansion—is unlikely to produce economic interdependence to a significant degree and will continue to represent a small fraction of each side's total trade.
- Sino-Soviet cooperation projects under 1986-90 plans are dwarfed by China's technical cooperation with Western countries.
- China prefers advanced Western goods and will continue to rely on the United States for equipment and know-how to develop its economy.
- Plans call for Beijing to ship more grain to the USSR, but the US share of corn and soybean exports to the USSR is not likely to be badly eroded, given the unreliability of Chinese harvests.
- Beijing is unlikely to export goods or technology that could enhance Soviet military capabilities or violate agreements it has signed with the West and thereby jeopardize China's access to Western technology.

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Nevertheless, Moscow and Beijing both have compelling motives to see that the goals for increased cooperation over the next few years are met:

- The leaderships in both countries have embarked on ambitious domestic reform programs, which they will find easier to develop in a climate of peaceful bilateral relations. Stronger economic ties can help promote that climate.
- Both sides believe that closer economic relations will strengthen their respective positions in dealing with the United States in the strategic Sino-Soviet-US triangle.
- Hard currency constraints plague both economies and could be eased somewhat by expanded bilateral barter trade that is governed by a clearing-account mechanism devoid of hard currency payments.

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In addition to these broad, overarching objectives, each country also has its own unique agenda:

- The USSR wants to accelerate economic development in its far eastern regions and seeks Chinese food and consumer goods to increase incentives for Soviet workers in the region. Moscow may even be considering using Chinese workers to cope with labor shortages that plague Siberian development. In addition, the Soviets see the huge, capital-starved Chinese economy as an ideal market in their drive to increase the share of machinery and equipment sales in total exports.

- China views the USSR as an appropriate outlet for many goods that are confronting—or will confront—Western trade barriers. The Soviets are also considered a good source for low-cost imports in the energy and heavy-industry sectors, where Soviet machinery and equipment—while not on a par with that found in the West—is sufficient for many Chinese needs at the moment. Sino-Soviet border trade provides an outlet for goods produced by China's less-developed western provinces, which often have difficulty competing with exports of the coastal cities.

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We believe Moscow and Beijing intend to continue seeking closer economic ties, but a number of barriers may frustrate their plans. Indeed, these obstacles may already have begun to take a toll on trade: through the first half of this year, Sino-Soviet trade was 16 percent below the level for the same period last year. Foremost among these obstacles are Beijing's continuing political reservations. China is reluctant to let extensive economic links lead it into another unequal relationship with the USSR, especially if Moscow refuses to meet Chinese security demands by reducing its troops along the border, ending its support for Vietnam's presence in Cambodia, and withdrawing from Afghanistan. For its part, Moscow may be wary of contributing to an even stronger China that could more effectively challenge Soviet goals in the Asia-Pacific region.

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Economic barriers will also impinge on further trade growth. Disputes over product quality have already surfaced, with both sides preferring to export their better goods to the West instead of to each other. This issue probably will grow as manufactured goods become more dominant in bilateral exchanges.

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On balance we believe that the high priority attached to closer ties by leaders in both countries will lead to some expansion of the Sino-Soviet economic relationship over the next few years. But the largest spurt in trade has already occurred; further growth is likely to be slow and may peak before the end of the decade. Thus, trade will not reach such heights as to pose major foreign policy dilemmas for either partner or for the United States.

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Scope Note

Growing Sino-Soviet economic relations have sparked the interest of US policymakers because of implications for the USSR's position in the Sino-Soviet-US strategic triangle and China's relationship with the West.

This paper takes a more complete look by examining the rapid expansion of Sino-Soviet economic relations in recent years, discussing both Soviet and Chinese motivations for improving economic links and exploring the avenues and obstacles to further trade growth.

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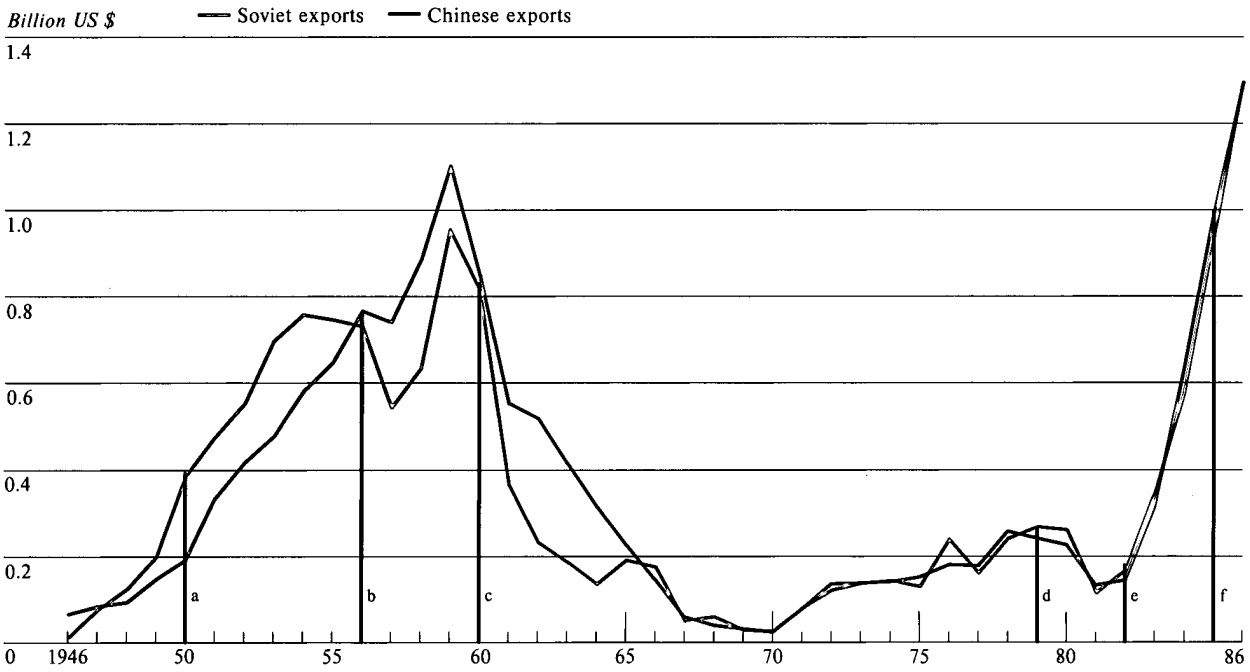
Figure 1
Sino-Soviet Trade, 1946-86



[a] Thirty-year treaty signed; USSR advances $300 million in long-term credits.
[b] Khrushchev launches de-Stalinization campaign.
[c] Moscow withdraws Soviet experts and cancels trade agreements in wake of Sino-Soviet border clashes.
[d] China adopts policy emphasizing consumption over investment, leads to decrease in capital goods imports.
[e] Beijing declares Open-Door Policy and opens talks with Moscow.
[f] Five-year protocol for trade and economic cooperation signed.

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USSR-China: Prospects for Revitalizing Economic Links

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Mutual Overtures Paying Dividends

Economic ties between the USSR and China have increased rapidly the past four years as leaders in both countries pursued the benefits of a closer relationship. In the early 1980s Beijing concluded that it no longer needed to harangue the United States into actively resisting Soviet expansion and that China could make gains in its relations with the Soviet Union and the Third World by distancing itself somewhat from the United States. This perception led Beijing to proclaim its "independent" foreign policy and reopen consultative talks with Moscow in 1982.

Although Moscow for some time has pushed for increased political and economic links to offset growing US influence with China, efforts have accelerated under General Secretary Gorbachev. In March 1985 in one of his first speeches, Gorbachev called for a serious improvement in relations with China, a concern he underscored shortly afterward by meeting with the head of China's delegation to former General Secretary Chernenko's funeral, Vice Premier Li Peng—the first such meeting between a Soviet general secretary and a Chinese official since the early 1960s. In addition, Gorbachev has replaced several "hardliners" in the Ministry of Foreign Affairs with personnel the Chinese consider more dynamic and flexible. In his Vladivostok speech last summer, the Soviet leader again called for better relations with China and went a step further to acknowledge some of Beijing's security concerns.

These tentative moves by both parties have already resulted in a sharp revival of trade between the two countries. Trade doubled in 1983 to nearly $650 million and by 1986 topped $2.5 billion (see figure 1). As a result, the USSR now ranks as China's fifth-largest trading partner; China has moved into 18th place among Soviet trading partners, compared with 42nd just four years ago.

The rapid increase in the volume of trade has been accompanied by a shift in the composition of goods exchanged (see figure 2). During most of the 1970s, the bulk of Soviet exports to China—although erratic and at low levels—consisted of machinery and transport equipment. China's decision to cut back on investment in favor of increased consumption in the early 1980s resulted in a sharp drop in Beijing's imports of Soviet machinery and equipment; by 1982 these goods made up less than 10 percent of Soviet deliveries, compared with nearly 60 percent in 1980. Since then, more liberal investment policies by Beijing have contributed to growing imports of Soviet machinery and industrial products. By 1986, machinery and transport equipment, including cars, trucks, and aviation equipment, as well as industrial inputs such as iron, steel, and nonferrous metals, had expanded to two-thirds of Chinese imports from the USSR.

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The rise in Chinese exports to the USSR has come mostly from large increases in food deliveries, including meat, soy beans, corn, fruits, and tea. These deliveries increased from a quarter of total sales in 1982 to nearly half of Chinese exports to the USSR in 1986. In addition, China delivered large quantities of clothing, as well as basic textile products, to Soviet industries.

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A small, but significant, part of this growth in economic exchanges has been the expansion of cross-border trade. Although such trade—which is conducted over and above the annual bilateral agreements—accounts for only about 3 percent of total trade, it has grown rapidly since it was permitted to resume in 1982 and is often played up by both Chinese and Soviet officials as an example of improved economic relations. Perhaps more important, such exchanges signify reduced tensions along the Sino-Soviet boundary, where serious conflicts erupted in the past.

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Border trade was largely channeled through central trade organizations that concentrate on delivering manufactured goods from factories in the interior

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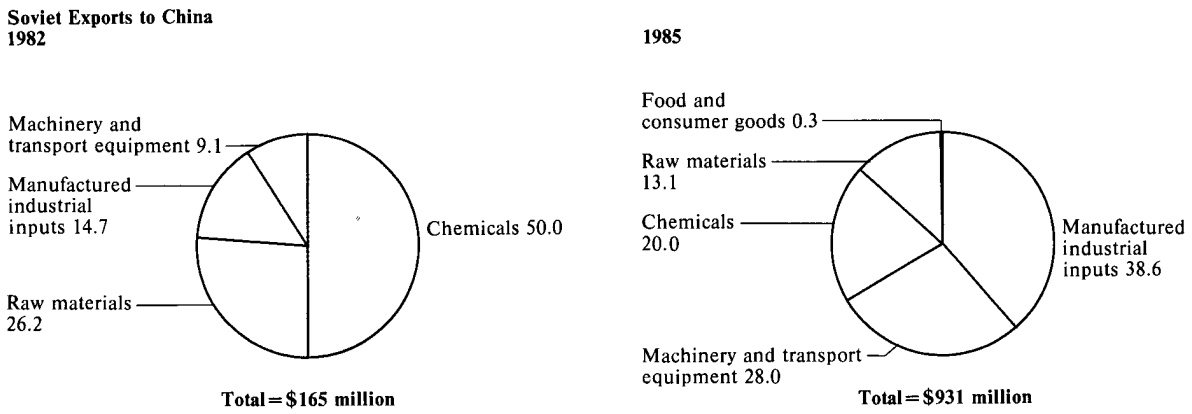
Figure 2
USSR-China: Composition of Trade



Source: Official Soviet and Chinese trade statistics.

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regions. During a visit by Soviet Deputy Premier Talyzin in September 1986, however, both sides agreed to further liberalize border trade to allow direct exchanges of locally produced goods. [redacted] border areas are now allowed to trade directly at the provincial/autonomous region level. To facilitate this trade, reciprocal trading offices have opened in Heilongjiang Province and Siberia, and additional offices in Xinjiang Autonomous Region and Kazakhstan appear to be in the offing. [redacted]

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The High Tide of Sino-Soviet Economic Relations

Economic relations developed rapidly between China and the USSR after the Chinese Communists came to power in 1949, with each country soon becoming the other's largest trading partner. Increasing by an average of 20 percent per year throughout the 1950s, bilateral trade reached $2 billion at its peak in 1959 and accounted for more than half of China's foreign trade and for one-fifth of Soviet foreign trade. China exported annually thousands of tons of minerals, metals, cotton, soybeans, rice, fabrics, and clothing. The Soviets delivered large quantities of oil products, ferrous metal, energy equipment, transport vehicles, and machinery and equipment for constructing turnkey industrial plants. In addition, Moscow sent thousands of workers and technicians to construct more than 165 major enterprises, turned over 24,000 scientific-technical documents including, free of charge, 1,400 blueprints for large enterprises to the Chinese and allowed 10,000 Chinese students to study in the Soviet Union.

Trade plummeted throughout the following decade as Moscow and Beijing severed ties in the wake of rising political and military tensions. No bilateral trade agreements were signed during 1967-69, and by 1970 trade had collapsed to $47 million. Although exchanges recovered somewhat once the signing of annual trade agreements was resumed in 1970, total trade averaged less than $350 million annually over the next 12 years.

Even with the rapid growth in recent years, Sino-Soviet economic relations are dwarfed by the "golden" cooperation of the 1950s. Last year trade exchanges still accounted for less than 3 percent of Chinese trade and only 1 percent of Soviet trade. The value of Sino-Soviet trade is only one-twelfth the value of Sino-Japanese trade, one-fifth that of Sino-US trade, and one-tenth that of Soviet trade with East Germany.

Room To Grow

Although the value of trade has now surpassed the peak attained during the 1950s, its volume and relative importance remain far below earlier levels (see inset). However, both Beijing and Moscow now see economic and political benefits to expanding further economic links. 25X1

Beijing's Agenda. Beijing's economic overtures toward Moscow are motivated, in part, by the need to balance the expansion in Sino-US relations with closer Sino-Soviet ties. The deeper, more visible ties China has forged to the West—and to the United States in particular—have increased the pressure on Beijing to demonstrate its commitment to an independent foreign policy. We believe China views improvements in Sino-Soviet relations as increasing its leverage with Washington in the strategic Sino-Soviet-US triangle. At the same time, however, Beijing is aware that US concerns over growing Sino-Soviet relations could jeopardize its access to Western high technology. Therefore it is moving carefully and slowly in reestablishing ties to Moscow, repeatedly reassuring US officials that China's fundamental view of the Soviet threat has not changed.

Beijing's willingness to improve relations with the Soviet Union is related also to the rise of Gorbachev. 25X1
When former General Secretary Brezhnev and former 25X1
Foreign Minister Gromyko managed Soviet foreign policy, China believed there was little prospect for improvement, and the Soviets' plodding and awkward diplomatic forays made it easy to rebuff Moscow without appearing intransigent. Gorbachev's flair for the international spotlight, alone, begs for a different response. But Chinese leaders also believe that Gorba- 25X1
chev sincerely desires better relations, and the expansion of political contacts—albeit slow and deliberate—probably represents a Chinese effort to probe the limits of his flexibility. 25X1

The Chinese place highest priority on political relations, but economic exchanges have expanded enough to offer Beijing several distinct advantages. Of special interest to the Chinese is reducing their growing hard 25X1

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currency trade deficits. China consistently ran surpluses for most of the early 1980s but has posted deficits since 1984. Its deficit with Western partners alone has more than tripled since 1983, to $16 billion last year, and Beijing is concerned that its hard currency position could worsen, especially if export plans are thwarted by growing Western trade protectionism.

Expanding trade with Moscow could ease hard currency constraints because Sino-Soviet trade is conducted on a clearing-account basis (see inset). Not only do the Chinese want an outlet for those exports likely to confront Western trade barriers, but they also see Soviet trade as a way to cut hard currency import costs. The less developed western provinces, in particular, can benefit from the import of Soviet capital goods to further industrialization. We believe Beijing is particularly amenable to Soviet technology in the energy and heavy industry sectors, with a special emphasis on projects involving thermal power, open pit mining, hydroelectric power, and long-distance electric transmission. In these areas, Soviet technology, while perhaps not on a par with Western technology, is advanced enough to meet some Chinese demands. Beijing can also benefit from Soviet assistance in areas where it has been unable to attract Western investment such as the modernization of heavy industry facilities originally designed by the Soviets in the 1950s.

Trade along the Sino-Soviet border also gives China's less developed western provinces access to an export outlet, since they often cannot compete with the exports of the coastal cities. These border regions can also serve as important conduits for other trade opportunities. Last year eight coastal regions held a symposium in the northeast province of Heilongjiang to discuss increasing trade with the USSR and now plan to sell goods to Heilongjiang Province, which will then market them in the Soviet Union.

Beijing is accepting a warmer economic relationship with Moscow while playing down any significant improvements on the political front. Nonetheless, the Chinese continue to insist that there can be no fundamental improvement in relations until Moscow reduces its threat to Chinese security. Specifically,

The Sino-Soviet Clearing Account

As with trade among most other socialist countries, the USSR and China exchange goods on a clearing-account basis. This practice is tantamount to a barter system since it provides for the direct exchange of goods for other goods with no currency changing hands. Temporary imbalances may occur but are expected to be settled over the course of future trade pacts. 25X1

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The Sino-Soviet clearing account differs from Soviet trade with other Communist countries in that trade is not valued in "transferable rubles"—an artificial, nonconvertible unit of account tied weakly to world prices—but in Swiss francs. The use of Swiss francs is probably intended to make bilateral trade more responsive to developments on world markets. When converted to dollars, Sino-Soviet trade has increased at a rate even faster than called for in bilateral trade protocols because of the depreciation of the dollar in recent years. For example, Sino-Soviet trade increased 29 percent last year in dollar terms but by only about 12 percent in terms of Swiss francs. Thus dollar figures for trade during the past three years have somewhat overstated the expansion of Sino-Soviet exchanges, while trade in the early 1980s is probably too low because the dollar was appreciating.

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China is demanding a reduction of the Soviet military presence along its border, an end to Soviet support for Vietnam's incursion into Cambodia, and a Soviet withdrawal from Afghanistan. Also of concern

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is the continuing Soviet naval buildup in the Pacific and Moscow's improvement in relations with North Korea in the mid-1980s.

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Beijing's willingness to expand its economic ties to Moscow in the absence of any palpable Soviet concessions on these obstacles, however, suggests that China

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has chosen to fine-tune its management of the Soviet threat. Underlying this shift is Beijing's judgment that its domestic reform program—including the ambitious military modernization drive—cannot succeed unless tensions with Moscow are reduced, leaving China more room to focus on domestic rebuilding. Thus recent warmer relations—political as well as economic—are, to some degree, an attempt by China to make progress in selected areas while continuing to improve Chinese military capabilities against the Soviet Union.

The View From Moscow. Soviet motives, in some respects, mirror those of the Chinese. Moscow wants to improve relations with China to offset US influence. The Soviets have long sought increased exchanges with China in the belief that decreased Sino-Soviet tensions will force the United States to take a more cautious approach in dealing with Beijing and, perhaps, to question the wisdom of helping China modernize its economy and defenses. Moscow also wants warmer relations with Beijing to restrict the US "China card," and thereby strengthen the USSR's position in dealing with the United States on a wide variety of issues. Thus Soviet officials publicly tend to exaggerate the pace of Sino-Soviet progress, hoping that highly visible trade and economic exchanges serve as tangible proof that relations are improving. Moscow also sees growing economic links, along with cultural and scientific exchanges, as a vehicle to improve political relations and eventually to persuade Beijing to accept the territorial and military status quo in Asia.

Gorbachev has also embarked on an ambitious program of industrial modernization and economic "restructuring" that will require much time and effort. A peaceful Sino-Soviet border can help him concentrate on his domestic agenda, and increased economic ties may help promote that peace. In addition, the USSR, like China, has found its hard currency position deteriorating in the wake of low oil prices and would also like to conserve its reserves by expanding barter trade.

We believe that Soviet plans to accelerate economic development in the Soviet Far East are a significant factor behind Moscow's desire to improve relations with China.

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Few details have been made public about Moscow's long-term program for Far East development, which Soviet officials indicate still is on the drawing board. But part of the program envisages expanded Soviet trade with all countries in the Asian and Pacific region, with a special role for China and other socialist countries. Moreover, Moscow also hopes to lay the groundwork for the exploitation of the region's largely untapped reserves of energy and raw materials.

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The first step of Gorbachev's strategy, consistent with his intensive economic approach in the European USSR, probably is to focus on increasing the labor productivity of workers in the Far East rather than on extensive growth through increased capital investments. One of the major problems in the development of Siberia and the Soviet Far East is a serious labor shortage brought about by outmigration and labor turnover. A Soviet survey of West Siberia, the best serviced region east of the Urals, showed that every sixth person intended to leave the area, partly because of the poor supply of food and consumer goods. Trade with China supports Soviet development of the region by providing goods that Gorbachev needs as increased incentives for workers. The Soviets are able to obtain food and consumer goods more cheaply from China than by shipping them from European parts of the USSR. The Soviets not only save in transportation costs but also are able to take advantage of China's success in recent years in becoming a low-cost producer of food and consumer goods through the rapid development of these industries.

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Moscow may also attempt to remedy the manpower shortage in the Far East by opening the door to Chinese workers. The Soviets have long entertained such thoughts; in the mid-1950s the Chinese agreed to a Soviet proposal that would have sent 200,000 Chinese workers to labor in Siberian forests, but the agreement was never fulfilled because of worsening political relations.

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China also represents an ideal market for Moscow's push to diversify the structure of Soviet exports. Rising production costs and lower prices on world markets have reduced Soviet profits on exports of energy and raw materials, leading Moscow to push for increased machinery and equipment sales to broaden the range of its exports. The Soviets have targeted the huge and capital-starved Chinese economy for an expansion of these exports. The fact that a large portion of Chinese industry was initially constructed using Soviet machinery and technology has already been an effective argument used by Moscow to secure a place in the planned renovation of some enterprises.

Foundations for Further Growth

During the past few years, a flurry of visits between Soviet and Chinese officials has set the stage for a further expansion of economic links (see appendix A on Sino-Soviet Bilateral Exchanges, 1984-87). The basis for most future trade plans rests with the trade and payments protocol for 1986-90—the first-ever five-year protocol—signed in July 1985. The long-term agreement provides a framework for conducting regular negotiations for annual protocols and sets a target of $14 billion for total trade during the period, as compared with the $4 billion traded during 1981-85. The Soviets and Chinese succeeded in boosting exchanges last year at a rate necessary to reach the 1986-90 target for total trade.

Cooperative Projects. As part of the signing of the 1986-90 trade and payments protocol, Soviet and Chinese officials also initialed an agreement for increased science and technology (S&T) cooperation. Although under the separate rubric of S&T cooperation, much of the agreement is tied closely to efforts to boost trade and, indeed, is included in planned trade exchanges. Negotiators have had difficulty, for the most part, agreeing on the scope and direction of S&T exchanges that go much beyond trade. Moreover, many of the bilateral S&T activities are managed by the Joint Commission on Trade, Economics, Science, and Technology (JCTEST), the same commission that oversees Sino-Soviet trade. 25X1 25X1

At the heart of future technical cooperation—if not the entire trade pact—is an agreement calling for the Soviets to provide equipment and technical advice for the renovation of 17 Chinese factories and the construction of seven new facilities during 1986-90. 25X1

In a departure from the usual socialist practice prescribing annual balancing of barter trade, Moscow has agreed to provide machinery and technical assistance for the projects on credit, allowing Beijing to pay with goods of equal value over an extended period of time. Although the Soviets do not appear to be providing concessionary terms or economic grants, as was the case during the 1950s, Beijing may eventually induce Moscow to provide some credit on such terms. According to the US Embassy in Beijing, the Chinese approached Gosplan Chairman Nikolay Talyzin during his September visit about the possibility of obtaining concessional loans, and the Soviets reportedly replied that, although such loans were possible, they could be discussed only in relation to specific contracts. 25X1 25X1

Preliminary negotiations for the projects focused on general areas of cooperation such as electric power, metallurgy, machinery, textiles, transport, chemicals, and coal extraction rather than specific projects. 25X1

Most of the projects are 25X1
in energy or heavy industry and are located in northeast China. In the largest single Sino-Soviet contract signed in recent years, China is buying 10 Soviet coal-fired thermal power generators for a total of $500 million for use in four power stations. Recently, a group of Chinese experts spent more than a month in the Soviet Union to work out the specifics on construction of one of the power plants to be built with

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Soviet assistance. Two other major projects are a coal mine in Heilongjiang and an electric transmission line along the Beijing-Tianjin corridor. Deliveries of machinery and equipment for the projects will not begin until 1988, although the Soviets already sent 100 technicians to China for work on the electric supply line (see appendix B for a more complete list of projects).

Moscow Pushes Other Machinery Sales. Moscow is seeking to boost sales of machinery and equipment in addition to those planned in connection with the cooperation projects. In fact, total deliveries of machinery and equipment and means of transport will account for 50 percent of trade with China during 1986-90 compared with less than a third in 1985, according to Soviet Deputy Minister of Foreign Trade Yevgeniy Bavrin. With purchases averaging $700 million annually, as compared with less than $300 million in 1985, China would rank among the top importers of Soviet machinery and equipment.

Moscow hopes that China's growing energy needs will offer trade opportunities above and beyond those spelled out under the current technical cooperation agreements.

Moscow is also anticipating that China must turn to nuclear power to meet its energy needs, and the Soviets are likely to continue pushing sales of nuclear energy equipment. Thus far China has been cool toward nuclear cooperation with the USSR. In 1985 Beijing turned down Moscow's offer to sell a large pressurized water reactor for China's Daya Bay project in southern China

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A visit by Chinese nuclear energy officials to Moscow in June 1986 yielded no accords, no doubt reflecting Beijing's safety concerns following the Chernobyl' accident. Soviet willingness to offer nuclear equipment on barter terms, however, may lead to some nuclear equipment sales as hard currency constraints limit China's cooperation with the West.

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Aircraft and aviation equipment are also likely to figure prominently in Soviet plans to export more machinery to China. Some Western analysts estimate that China must purchase as many as 300 passenger aircraft over the next 10 to 15 years at a cost of about $7 billion to meet its fast-growing transportation needs. Already in 1986 China ranked second in imports of Soviet aviation equipment behind India, with purchases worth $160 million. According to a Western press report, Chinese and Soviet officials have indicated that Beijing will become the biggest buyer of Soviet aircraft during the 1986-90 plan period. Nonetheless, Soviet sales are likely to remain small compared with those from the West. Since 1980, the Chinese have purchased US aircraft worth more than $3 billion.

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The Soviets, presumably with low-priced equipment, are also trying to enter the extremely competitive market for locomotive sales to China. A Soviet trade official told US Embassy officers in Beijing that China plans to purchase 200 Soviet electric locomotives for about $250 million. The Soviets will be required to undertake special design work to fulfill the agreement because Soviet and Chinese railway gauge standards differ. The Soviet also stated that the Chinese agreed "in principle" to import 7,000 units of Soviet-built railway stock during 1986-90.

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Further Soviet Initiatives. Moscow seems to be going to great lengths to ensure the success of the technical cooperation pact. A Soviet office opened in Beijing in March 1986 just to oversee technical cooperation projects between the two countries. The office, headed

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by deputy counselor of economic affairs A.V. Goriunov, is the first to be located outside the Soviet Embassy compound and has an eight-man staff that may be expanded to 20 as technical cooperation develops. In discussions with US Embassy officials, Goriunov sharply distinguished his office's activities from those of the Soviet Embassy trade representative's office, which handles traditional bilateral barter trade.

Moscow is also proposing the formation of joint ventures with China and direct enterprise ties between Chinese and Soviet firms. the primary type of such cooperation will be the delivery of Soviet machinery to reequip light industrial enterprises and the supply of raw materials such as leather, down, fur, and textiles for the Chinese to process into finished goods for reexport to the Soviet Union. Other projects discussed include:

- The building of Soviet passenger cars in China with assemblies and subassemblies provided by the USSR.
- The coproduction of power-generating equipment, railroad cars, and metal-making machinery, as well as the production in China of spare parts for the machinery and equipment imported from the USSR.
- The establishment of "export bases" in China to ship agricultural products to the USSR in exchange for supplies of agricultural equipment, fertilizers, and other products.

Beijing's Export Priorities. China's export push to the USSR will continue to center on textiles and food products:

- In addition to fabrics and finished clothing, the Chinese want to deliver raw cotton and silk.
- Meat and meat products will be a major growth item
- The two countries signed a long-term agreement last year for the export of 1.5 to 1.8 million tons of corn to the USSR annually, and plans also call for greater Chinese exports of soybeans and possibly other feedgrains.
- Moscow reportedly also wants to buy large quantities of the strategic metals molybdenum, vanadium, and silicon, which are used mainly as alloying agents in steel production 25X1

Beijing's policies promoting exports to the Soviet Union somewhat mitigate the desires of Chinese enterprises to divert sales to the West to earn foreign exchange. For example, the US Consulate in Shanghai reports that enterprises that export to the Soviet Union can earn foreign exchange allocations on the basis of the amount of hard currency saved. Moreover, some countertrade arrangements with the USSR are very profitable, with the Chinese-manufactured products selling for three to four times the value they could command on the international market. 25X1 25X1 25X1 25X1

Prospects: Pause or Downturn?

We believe that the political and economic motivations behind the recent expansion of Sino-Soviet ties will continue to lead both countries to seek closer economic links. Moscow and Beijing place a high priority on the fulfillment of current long-term trade and technical assistance agreements to maintain momentum in the drive for warmer political relations. 25X1

Nonetheless, we believe that trade is unlikely to continue growing at the rapid pace of the past few years and will remain relatively small—in real terms—compared with the high levels that characterized Sino-Soviet exchanges during the 1950s. Many obstacles—both economic and political—already may have begun to take a toll on trade. Soviet statistics show that first-half Sino-Soviet trade this year fell 16 percent compared with last year, with both exports and imports falling short of planned targets. 25X1

Most of the large Soviet machinery and equipment deliveries tagged for Chinese industrial projects are not scheduled to begin until 1988, supporting the argument that the decline in trade may be only a pause in expanding economic relations. Such 25X1

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talk may be wishful thinking, however, and Moscow and Beijing may be forced to adopt more aggressive measures to overcome trade barriers that threaten to put a cap on the recent trade boom.

Quality Constraints. The major obstacle to future trade growth results from the inherent weaknesses of a barter trade system. Although barter and clearing account trade allows the Soviets and Chinese to obtain goods without paying cash, this arrangement suffers because each side has few incentives to supply its best quality goods. Chinese and Soviet officials admit that first priority goes to earning hard currency and the barter system gets leftovers, according to the US Embassy in Beijing. This drawback is not as serious when exchanges consist largely of raw materials and basic industrial goods, which, in terms of quality, do not differ greatly from similar goods found on world markets. However, the USSR wants to export more machinery, equipment, and other goods that are more likely to compare poorly with Western alternatives. Trade negotiations could become more cumbersome and arduous as price and quality questions loom larger.

The poor quality of many Soviet products may hamper attempts to boost trade between the two countries. A number of Chinese and East European officials have said that the drop in Sino-Soviet trade this year may be a result of weakening demand for Soviet machinery and equipment on the part of Chinese industrial enterprises. These enterprises—supposedly free under Chinese planning reforms to choose their own suppliers—reportedly complain that most machinery and equipment offered by the Soviets is inferior to that available from the West and, moreover, that the Soviets are unwilling to sell their most sophisticated technology. One informed Soviet diplomat acknowledges that the USSR is incapable of producing a number of goods that the Chinese seek.

The poor quality of Soviet machinery is already complicating the implementation of the proposed 24 economic cooperation projects. In fact, one Chinese official recently indicated a number of projects on the proposed list have already been canceled, according to Embassy reporting. Many of the Chinese enterprises designated to be upgraded are balking at using Soviet machinery and equipment 25X1

Also hindering cooperation on the projects are differences over the use of Soviet technicians and the extension of credit for the projects. 25X1 25X1

Soviet aircraft, with high maintenance and fuel costs, face considerable resistance from Chinese airlines, which prefer Western aircraft. 25X1

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Domestic Reforms and Competing Demands. Growth in economic relations in the longer term will also be influenced heavily by efforts to modernize Chinese and Soviet economies. On one hand, Moscow's program of improving the quality of Soviet machinery and equipment—with a goal of bringing 75 to 95 percent of these goods up to world market standards by 1990—holds out the promise that Soviet exports may become more attractive to Chinese buyers. Yet this ambitious goal is unlikely to be reached, and, even if some successes are registered, the pressure on Soviet central planners to increase hard currency exports may leave little room for substantially more quality goods to be directed toward Beijing. Moreover, as Soviet enterprises themselves become freer to seek their own markets under Moscow's trade reforms, they are likely to boost exports first to hard currency customers. For its part, Beijing hopes that a substantial investment in technological renovation of certain industries will allow it to reduce imports of many of the industrial raw materials that now form a large part of Soviet exports to China. Over the longer 25X1

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term Beijing even hopes that its demand for imports of Soviet machinery and equipment will diminish as its own industry develops.

Both domestic demands and hard currency shortages are already taking their toll on Sino-Soviet exchanges:

- Beijing has been forced to restrict grain sales to the Soviets by growers in China's northeastern provinces because of grain shortages in other areas, according to US Embassy reporting.
- China also has been unable to deliver cotton on schedule this year because of a poor crop and unexpectedly large domestic demand

Transportation Bottlenecks. The poor transportation infrastructure between the countries, particularly at the major border transshipment points in northeastern and western China, is also expected to constrain trade. Chinese and Soviet officials already have expressed concern over the ability of the system to handle large increases in Sino-Soviet trade. The volume of freight shipments as part of bilateral exchanges is scheduled to increase from 7.1 million tons in 1985 to 12 million tons in 1990.

To alleviate the strain, a working group has been set up as part of JCTEST to develop railway, sea, river, and automobile transport. A number of measures already have been taken:

- Several joint railroad projects are planned including an extension of the railroad in Heilongjiang Province northward to Heihe on the Soviet border scheduled for completion next year, and a westward extension of the railroad ending at Urumqi in the Xinjiang Autonomous Region to the Soviet border.
- A new airline route connecting the USSR, China, and East Germany opened recently because of the increased demands arising from expanding trade, according to press reports.
- The Soviets announced that river shipments along the Amur River were resumed last year, and China opened the port of Tongjiang in Heilongjiang Province to accommodate increased exchanges of Chinese soybeans and corn for Soviet lumber. 25X1 25X1

Unanswered Political Questions. Bilateral economic exchanges will remain vulnerable to political difficulties, particularly in the absence of fully normalized relations. Despite the reforms in both countries that aim at greater enterprise independence, the lion's share of trade probably will continue to be carried out by state-owned foreign trade corporations that respond to central government directives. The Soviets certainly will be wary of the potential of an economically stronger China that could more effectively challenge Moscow's goals in the region. Thus Moscow is likely to hold back on deliveries of top technology and goods, while pushing second-rate products in barter- 25X1
ing for Chinese food and consumer goods. 25X1

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the Chinese remain "apprehensive" over a return to large-scale Soviet economic assistance, and they probably will limit Soviet involvement in China's infrastructure development. Beijing's resolve to avoid another unequal relationship with Moscow will preclude the type of economic ties that could lead to extensive economic dependence on the USSR. 25X1
Moreover, Beijing's resolve to expand economic relations with the USSR may also weaken if the economic advantages to the relationship begin to appear less clear cut. Chinese leaders have settled for slow progress in achieving many of their political objectives vis-a-vis the Soviets as growing ties brought concrete economic gains. However, the quick gains from expanding trade may be exhausted, particularly if the low quality of Soviet machinery and equipment becomes a more important issue. Beijing may begin to react more strongly to foot-dragging by the Soviets in addressing China's security concerns. By allowing trade to slow down, Beijing would send a strong signal that Moscow cannot expect progress in expanding economic ties in the absence of a closer political bond.

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In pacing growth in economic links, Moscow and Beijing also must consider the effect on relations with other countries. The fast expansion in trade ties undoubtedly has been viewed as a precursor of warmer political relations by Vietnam, Mongolia, and Afghanistan—Soviet allies that are directly affected by China's security demands—and by countries such as North Korea and India that are involved in their own triangular relationships with China and the USSR. According to US Embassy reporting, Gorbachev was surprised by the sharp questions posed by Indian journalists regarding Sino-Soviet relations during his recent trip to New Delhi. While Sino-Soviet trade thus far has prospered despite third-country concerns, attempts to accelerate trade would probably raise sharper reactions.

Implications for the United States

Expansion of economic relations between the USSR and China, along the lines currently planned, is unlikely to produce significant economic interdependence. The $14 billion in planned exchanges for 1986-90, even if accomplished, will still represent a small fraction of both countries' overall trade. Even the 24 Sino-Soviet cooperation projects currently on the books will be overshadowed by the thousands of technology import contracts China has signed with the West. Beijing's hard currency problems raise the possibility of additional advances toward Moscow to gain economic relief, but Chinese determination to avoid excessive economic entanglement with the Soviets, particularly in the absence of progress in political relations, probably will deprive Moscow of economic leverage that could precipitate significant changes in Chinese policies.

We believe that expanding Sino-Soviet trade will have only a slight impact on US trade with China. China has a clear preference for advanced Western goods and will continue to need US expertise and equipment for development of its industries, services, and infrastructure. Beijing will, however, use every opportunity to use barter rather than foreign exchange, which could impinge on its trade with the United States. For example, increased purchases of Soviet raw materials or low-level technology goods such as timber, nitrogen fertilizer, selected industrial chemicals, and basic machine tools—while only a small part of China's trade with the United States—may dampen some US sales. 25X1

At first glance, expanding Sino-Soviet trade could have a greater impact on US trade with the Soviet Union. With corn and soybeans making up 60 percent of total US exports to the USSR, Moscow's plan to boost grain purchases from China over the next five years could cut into the US share of exports to the USSR. The unreliability of Chinese grain exports, however, may prevent Moscow from relying heavily on Beijing as a supplier. China already has been forced to cut back exports of corn this year to some buyers and is expected to sharply increase imports of wheat. 25X1 25X1

We believe that Sino-Soviet trade is highly unlikely to serve as a conduit for the transfer of sensitive Western technology to the USSR. While improved relations may have reduced the likelihood of a military conflict, Beijing has not lowered its vigilance and will avoid exporting goods or technology that could enhance Soviet military capabilities. Moreover, China calculates that technology transfer concerns in the West could jeopardize access to the technology it seeks and delay, if not reverse, the gradual easing of US and multilateral export controls. 25X1 25X1

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Appendix A

Sino-Soviet Bilateral Exchanges, 1984-87 [1]

December 1984
Soviet First Deputy Premier Arkhipov visits Beijing, the highest ranking direct Sino-Soviet contact in 15 years:
- A significant expanded trade agreement is signed as well as new agreements on economic cooperation and exchanges in culture and S&T.

March 1985
Chinese Vice Premier Li Peng represents China at the funeral of Soviet General Secretary Konstantin Chernenko. While in Moscow, Li meets with the newly appointed General Secretary, Mikhail Gorbachev.

July 1985
Chinese Vice Premier Yao Yilin reciprocates Arkhipov's late 1985 visit:

- Agreements on trade and economic cooperation for 1986-90 signed. Trade agreement establishes the framework for negotiating annual trade protocols that are set to total $14 billion over the five-year period. Economic cooperation agreement permits China to pay over a multiyear period for imports of capital goods and technical assistance acquired under that pact.

December 1985
At Gorbachev's invitation, Chinese Vice Premier Li Peng stops in Moscow on his way home from Eastern Europe. The two discuss bilateral relations and some international issues, according to official Chinese press.

January 1986
Soviet First Vice Deputy of Foreign Trade G. K. Zhuralev heads a transport and trade delegation to Beijing and meets with Li Peng and Minister of Foreign Economic Relations and Trade Zheng Tuobin:

- Summary of talks on transport of foreign trade for 1986-90 signed.

- Exchange of letters initiating border trade between China's Xinjiang Autonomous Region and the Kazakh, Tadzhik, Turkmen, and Uzbek Soviet Republics, as well as the Krasnoyarsk Oblast and Altay Kray.

March 1986
Arkhipov returns to Beijing to cochair the first Joint Commission on Trade, Economics, Science, and Technology (JCTEST) and meets with Premier Zhao Ziyang, Li Peng, and Vice Premier Wan Li:
- An accord boosting bilateral trade and technical cooperation signed at the close of the JCTEST.

April 1986
- Agreements signed to facilitate the use of border rivers and ports for trade.
- Chinese officials acknowledge to US Embassy officers that direct talks between the Chinese and Soviet national airlines are planned.

May 1986
- Soviets sign an agreement with the Ocean Shipping Agency in Beijing that permits Soviet and Chinese shipping offices to set up in Odessa and Shanghai, respectively. Accord also stipulates that logistic services for Soviet merchant vessels will be initiated in all Chinese ports and that Soviet merchant ships' nonproductive berthing time in Chinese ports will be greatly reduced.

August 1986
- Protocol on exchanges of trade exhibitions signed at the opening of the Beijing exhibition in Moscow.

September 1986
First Deputy Premier and Chairman of the State Planning Committee Nikolay Talyzin visits Beijing. Accompanied by the Chairman of the Soviet State Committee for Foreign Economic Relations, the Minister of Timber, and Deputy Foreign Minister Igor

[1] The use of bullets (•) indicates exchanges in which trade agreements or protocols were signed or negotiated.

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Rogachev, Talyzin meets with Zhao Ziyang, Yao Yilin, Li Peng, Vice Foreign Minister Quan Qichen, and head of the State Planning Commission Song Ping:

- A cooperation agreement signed between the Chinese and Soviet state planning bodies that establishes a framework for and an endorsement of the program drawn up for trade and technical exchanges during 1986-90.

- Agreement to liberalize cross-border trade signed, allowing border provinces to trade directly in locally made goods.

October 1986
- Agreement signed establishing a committee to oversee joint development of the Amur River where it forms the boundary between China and the Soviet Union. Projects will include joint planning for cooperation in power generation, flood prevention, navigation, and water utilization.

- Protocol signed calling for scientific research cooperation in a number of fields, including agriculture, energy, machine building, metallurgy, and transportation.

December 1986
- Soviet trade and industry exhibition opens in Beijing.

February 1987
Chinese Vice Foreign Minister Qian Qichen and Soviet Deputy Foreign Minister Igor Rogachev hold the first round of border talks since 1972 in Moscow.

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March 1987
- Annual trade protocol for 1987 signed in Moscow.

May 1987
Vice Premier Yao Yilin heads the Chinese delegations to Moscow for the second annual JCTEST meeting.

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Appendix B

Sino-Soviet Technical Cooperation Projects

In July 1985 China and the Soviet Union signed a five-year agreement to cooperate in the renovation of 17 Chinese plants and the construction of seven new Chinese facilities. Subsequent discussions have centered on the sectors to be covered in the projects, as well as specific sites for cooperation. Neither side, however, has yet provided a complete list of the projects under discussion, and we suspect they are having difficulty agreeing on many of them.

The following list identifies a number of the projects that have been discussed as possible candidates for cooperation. Several apparently predate the 1985 agreement, and we do not know if they are counted under the accord or as independent projects.

Energy

Electric transmission (2)	Locations uncertain. Press reports say one line will connect Shanxi and Hubei Provinces; another will run from Jilin to Heilongjiang Province. The Soviet list of projects includes a 1,000-kilometer (km), 500-kilovolt transmission line at an unspecified location.
Coal (5)	Open pit mine at Yiminhe (Inner Mongolia) with annual output of 20 million tons. Soviet feasibility study approved by Chinese in late 1986.
	Coal-concentrating (possibly coal-washing) mill, possibly for Yiminhe coal mine.
	Renovation and development of Xingangtai Coal Mine in Hegang (Heilongjiang) originally developed with Soviet assistance. Apparently independent of 24 projects covered by the technical cooperation accord.
	Qixiang Coal Dressing Factory (Heilongjiang)
	Matou Ore Dressing and Coal Mining Plant (Hebei). Soviets to design plant with the aid of Leningrad State Mine Dressing Institute; will supply coal-washing equipment and technology.
Thermal power stations (7)	Three stations, each utilizing two generators. Total power generation 3,600 to 3,800 megawatts. Probable cost: $800 million. Locations: Shanghai, Yiminhe (Inner Mongolia), and Jixian (province unknown). Designs completed in early 1987.
	Four stations, using a total of 10 generators. Contract, worth $500 million, signed December 1985. Total power generation: 2,100 megawatts. Locations: Zhanze (Shanxi), Huangdao (Shandong), Mudanjiang (Heilongjiang), and Shuangyashan (Heilongjiang).

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High-voltage porcelain insulator plant (1)	Located in Xian (Shanghai). Upgrade of plant built during the 1950s with Soviet assistance.
High-voltage circuit breaker plant (1)	Located in Xian. Upgrade of plant built in 1953 with Soviet help. Chinese dissatisfied with Soviet technology; cooperation may not take place.
Insulation plant (1)	Located in Xian. Upgrade of plant built during the 1950s with Soviet assistance. Chinese unhappy with Soviet technology; may cancel cooperation plans.

Metallurgy

Iron and steel works (3)	One at Anshan (Liaoning), one at Baotou (Inner Mongolia), and one at Wuhan (Hubei). All were built in the 1950s with Soviet assistance. Contract for Wuhan, worth $293,000, already signed.
Aluminum plant (1)	Located at Fushun (Inner Mongolia). Renovation of plant built with Soviet assistance in 1954.
Copper-processing plant (1)	Tube and rod shop located at Luoyang (Henan).

Transportation

Railroad electrification (1)	Length of rail line to be electrified: 1,000 km. Location unknown.

Chemicals

Synthetic rubber plant (1)	Location uncertain; possible upgrade of Lanzhou Synthetic Rubber Factory (Ganu) built with Soviet assistance in the 1950s.
Chemical fertilizer plant (1)	Part of a chemical complex; location uncertain, possibly Taiyuan (Shanxi). Soviets reportedly will supply ammonia-based fertilizer technology.
Timber hydrolysis plant (1)	Located in Nancha (Heilongjiang). Upgrade of plant built by Soviets in 1957. Makes alcohol for pharmaceuticals.

Other

Ball bearing plant (1)	Location uncertain, possibly Luoyang (Henan) or Harbin (Heilongjiang). Upgrade of plant built during the 1950s with Soviet assistance. German complex to furnish and install equipment.
Tractor plant (1)	Located in Luoyang (Henan). Upgrade of plant built in 1959 with Soviet assistance.
Pulp and paper mill (1)	Located at Jiamusi (Heilongjiang). Upgrade of Soviet-built plant dating from 1950s. To be completed in 1989. Cost: $25 million.

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Textile factory (1)	Located at Harbin (Heilongjiang). Upgrade of Soviet-built flax factory built in 1952. Renovation began in 1984, but the project was subsequently listed as one of the cooperative projects under the 1985 accord. Explosion at factory in March 1987 may delay work on the project. Cause of the explosion is unknown.

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